Preparing for the next generation: Legal considerations in bringing aboard younger dentists

The practice of dentistry, as with the practice of medicine, has seen trends towards consolidation, albeit at a slower pace.¹ Perhaps more so than physicians, dentists have traditionally been sole practitioners with fewer specialists.² But with pressure ranging from an older population, increased reliance on public and personal payments for services and increased reliance on technology, dentists face critical decisions as they consider future retirement or other exits from their practice. They will look to either acquisition (sale of the practice) or a more homegrown plan for the future by bringing aboard younger associates.

Outright acquisition usually entails the transition of a business owner to an employee—with accompanying loss of control with regard to management, compensation, finance and treatment philosophy. Passing along the practice from within, in contrast, has many benefits in handling what is very much perceived as a family business, even more so than medicine.

The senior dentist may, for example, hire a younger dentist straight out of dental school. The advantages are that personality and treatment philosophies of the younger dentist are not quite set, and the senior dentist, with enough time and financial investment, can train someone to reflect a similar approach to maximize continuity of treatment. The new graduate may have considerable educational debt, but no invested capital at risk yet.

Partnering with another, more established, dentist minimizes training but carries more risk as the respective practices must be measured and the combination of even two solo practices requires work similar to what any merger & acquisition (“M&A”) transaction entails, including involving legal, accounting and other professionals. Existing practices must account for many issues such as combination/elimination of leases, third party consents, staff capacity, workload, compensation and succession planning in the event of death or disability.

Regardless of methodology, done well and done correctly, the senior dentist will be able to transition the practice over time and maintain a desired quality of life and some assurance that the practice will be in good hands as time goes on.

This article addresses the basic legal considerations facing an established, small general dental practice as they make the decision to bring in younger dentists in the face of increasing pressure and time commitment in the modern dental practice.

LEGAL CONSIDERATIONS
1) Associate Employee/Independent Contractor Status: When dentists hire an associate, the question will arise whether the associate will be an employee or independent contractor. The answer lies within a combination of state and federal (Internal Revenue Code) laws, and has major bearing on employment taxes and benefits coverage. The authors have seen both classifications, and believe the “independent contractor” classification will be rare in the context of younger associate dentists, and particularly if the main incentive is to avoid withholding taxes and coverage of health and retirement benefits. The consequences for misclassification can be severe and far outweigh the costs of proper treatment from initial hire.

The most important set of rules in evaluating classification of an associate as an employee versus independent contractor exists within the Internal Revenue Service (IRS) rules. The IRS rules govern federal tax withholding. Treatment as an employee means additional tax costs for the employer, as employers must not simply withhold the employee’s share of income and FICA/Medicare tax, but match it (for 2014 an employer’s share of the FICA tax is 6.2 percent of the employee’s wages up to $117,000 and employer’s share of the Medicare tax is 1.45 percent with no wage
cap). There also are state tax payroll costs. (Missouri has, for example, state income tax withholding and state unemployment insurance to consider.) Employee payroll costs are by no means insignificant.

But the classification as an independent contractor is not simply elective—the IRS has 20 factors it reviews in determining whether a worker should be treated as an employee or independent contractor.¹ The practice may not have a choice. Even a written agreement may be insufficient to achieve classification as a bona fide independent contractor, particularly in the case of associate dentists who, in reality, work only for one or two supervising practices. In essence, if a supervising practice controls an associate dentist sufficiently, taking into account three categories of evidence (described below), the associate dentist must be treated as an employee.

Incorrect classification may result in very severe penalties costing far more than the tax cost if correctly paid originally. Workers themselves can actually request that the IRS review their classification—in essence, trigger an inquiry in which the employer must respond—by filing a Form SS-8 with the IRS. This increases the need to make the correct decision early on.

The IRS will look at three categories that evidence worker control: A) behavioral control over the worker, B) financial control over the worker and C) general relationship factors.

A) Behavioral Control. These are factors that show a dental practice has the right to direct and control how an associate dentist does the assigned tasks—when and where to do the work, what equipment to use, who may assist the associate, what tasks to perform, what order and sequence to follow, and how much training is provided. Bona fide independent contractors are paid to achieve a result, but the party contracting them does not direct the details of how the result is accomplished. In general, the supervising practice will nearly always have behavioral control over younger associate dentists, regardless of the time/frequency of patient visits. But even this category is susceptible to different characterization. For example, if the associate dentist has some years of experience, or is covering patients with little supervision, a better argument can be made that there is little behavioral control. The complexity of the practice of dentistry cannot always be likened to other professions that the independent contractor rules were designed to cover.

B) Financial Control. These include qualitative business (as opposed to practice) factors that demonstrate a practice’s control over an associate dentist. Independent contractors typically cover their own expenses (such as malpractice insurance). Independent contractors will have a significant investment in their own practice in terms of equipment. They will usually make their services available to a target market. Finally, their compensation is not typically guaranteed by hour, week or other time period. If a practice considers independent contractor status for its associate dentists, compensation arrangements should take into account limitations by actual collections, very limited (as opposed to broad) non-competition agreements (if any), and requiring the associate dentist to cover his or her own malpractice insurance. These factors often prove unrealistic for associate dentists without the ability to have a self-sustaining practice.

C) General Relationship Factors. The IRS will look at the documented, actual working relationship between the practice and the associate dentist. A written contract between the practice and the associate dentist describing the relationship is necessary, although not determinative. The treatment with respect to employee benefits should be consistent with any such written contract. The permanency of the relationship is focal as well—realistically, an indefinite term (particularly for an associate dentist trying to establish roots in the community as opposed to a temporary position) will have bearing on classification.

Given the importance of the classification of the associate dentist, the senior dentist will find it wise to approach new hires by giving consideration to the following:

i) Short- and Long-Term Goals for the Relationship. Is the associate dentist being hired primarily as a long-term solution for future practice takeover? Or will he or she mainly assist in various procedures and cover during the primary dentist’s absences? Be realistic and honest in such expectations. Assess, if possible, what the associate prefers doing and his or her long-term practice philosophy.

ii) Budget Revenues and Expenses Accordingly. Work with the practice administrator and accountants in determining potential revenues using both classifications.

iii) Invest in a Well-Drafted Employment or Contractor Agreement with Counsel Very Familiar with the Tax and Benefits Rules Relating to Employees. Ensure payroll and bookkeeping reports are consistent with such treatment. Depending on the capability of the associate to work elsewhere, recommending to the associate that he or she incorporate his or her practice (such that the contract is with the professional entity) may considerably help support true independent contractor status. If eventual co-ownership of a practice is contemplated, avoid directly incorporating any details in the employment or contractor agreement (other than a general statement of intent to evaluate the possibility when the time comes). Details should be handled only if there is real commitment and capability to co-own.

iv) Invest Time in a Workable Compensation Formula. Compensation for associate dentists may not be on a fixed annual salary basis; rather, common are formulas that promise a certain percentage (i.e. 30 percent) of revenues collected from services performed by the associate dentist, or a percentage of revenues actually collected by the practice, or a combination of a base salary and productivity. A fixed advance payment may be made, subject to periodic adjustment. There may be carve-outs for specific procedures. These formulas should be clear and specific, with general terminology avoided. Access to the formula’s calculation and supporting documentation should be made available to the associate dentist upon request.

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2) Considering Equity Ownership for the Associate. After an associate dentist has worked for a comfortable amount of time, or if an incoming associate has a fairly established practice, the senior dentist may want to evaluate options to provide the associate with equity ownership.

A) Evaluate Existing Practice Structure and Existing Federal Tax Treatment. Assuming the personalities and practice philosophies mesh (admittedly a big assumption), the legal analysis starts with evaluation of the current legal structure of the primary practice and its federal tax structure. The existing federal tax structure weighs heavily on options to bring in new associates and partners.

Options differ depending upon whether the primary practice entity is taxed, for federal income tax purposes, as a corporation, an “S” corporation, or a partnership/sole proprietorship. A dental practice which is treated as a “C” corporation files federal Form 1120 annually, although this status is typically not the most tax-beneficial structure. As a result, this classification is less common. Key disadvantages of a “C” corporation are (1) double taxation (taxation of net income first at the corporate level, and second as net income is distributed); and (2) taxation as a “personal service corporation,” which limits the benefits of lower tax rates at lower net income levels. Should the primary practice be a “C” corporation, consideration should be given to restructuring to obtain better tax results.

The “S” corporation (which files annual Form 1120-S with the IRS) is a common tax choice for a small, individually-owned practice, in part due to the ability to better control the amount of employment taxes paid by “S” corporation shareholders. The trade off is a more restrictive structure. “S” corporation distributions of net profit, after payment of compensation, must be distributed strictly in proportion to the ownership of “S” corporation shares (as do allocation of profits and losses, which must always be made in such proportion). New “S” corporation shareholders must also generally provide a minimum, reasonable, capital contribution in connection with their buy-in. “S” corporation shareholders must generally also be individuals and not entities.

Practices may also be treated for tax purposes as partnerships or sole proprietorships (reporting to the IRS using either Form 1065 or Schedule C of the sole owner’s Form 1040). In some cases, the legal entities may be structured as limited liability companies, or “LLCs,” and taxed as partnerships or sole proprietorships. Practices structured as these forms of entities have more flexibility in determining how to bring aboard new equity owners. In particular, the ability to vary the allocation of profits and losses is a benefit where the ability or desire of the associate dentists to incur additional debt is very limited. Conceptually, the partnership requires education to get comfortable with new concepts and terminology beyond simply owning shares, and a partnership agreement (or an operating/limited liability company agreement, in the case of an LLC) can be extremely lengthy and technical. Dentists should invest their time and money in having quality-drafted agreements prepared, understanding them, and ensuring that CPAs are involved from the beginning. Doing so may increase legal and accounting fees at the forefront, but money is well spent early in the process to ensure a strong foundation. Higher fees are required to unwind or “fix” faulty documents and arrangements later. And while it can be tempting to save on legal fees by retaining just one attorney for both parties, good attorneys will be reluctant to take on both parties even if conflict waivers are signed. Consider budgeting for separate counsel in such a critical transaction.

B) Consider Appropriate “Buy-In” (Capital Contribution) for the Associate. Given the capital investment required for a practice, the best route is almost always to have at least some amount of buy-in, as opposed to an outright award of an interest in the practice (and such decisions should always be made with consultation from legal counsel and CPAs/tax advisors early in the process).

Outright awards of interest in the practice can inadvertently trigger taxable income, which will require payment of tax even where no cash is paid. A common mistake is to have an agreement to take reduced compensation in exchange for an interest in the practice—this creates tax exposure for both parties.

If the practice is taxed as a partnership, you may consider offering a “profits interest” to new associates, which does not award the associate an actual interest in existing capital of the practice, but still offers the opportunity to participate in future growth.

A new associate with an interest in the practice should take into account the regular need for capital and equipment investment as technology changes and as equipment becomes outdated. Typically, new associates will be expected to bear part of any practice debt. The assumption of existing debt is usually part of consideration “paid” for an interest. For example, the associate may be required to sign on as a guarantor of existing debt and leases.

C) Consider Desired Compensation for Services Rendered and Distribution of Other Profit. The element of compensation, once an interest in a practice is shared, will incorporate not only compensation from services rendered, but also participation in revenues from hygienists and revenues from more profitable procedures (cosmetic) that may not be performed by a particular dentist within the practice. For example, a new associate may own 10 percent of the practice, which would entitle or obligate him or her to 10 percent of all net profit or loss remaining after revenues and calculated compensation is paid. The dentists may agree to fairly complex compensation arrangements which eventually “zero out” all net profit. Some formulas may be specific enough to allocate expenses of particular supplies and assistants to each member (essentially amounting to more of an office sharing arrangement). Payment of compensation, versus distribution of net profit after expenses, can result in some tax planning opportunities. Administrative and management work may also be taken into account.
The compensation element should be reflected in a services agreement, or contractor/employee agreement, depending on the situation.

D) Consider Governance Issues and Invest Time in Properly Drafted Governing Documents. The actual practice entity will need its governing documents amended to account for the new business relationship. If the senior dentist has traditionally been the sole owner in the practice, he or she should prepare for a far more lengthy partnership agreement (for general or registered limited liability partnerships (LLPs)), limited liability company/operating agreement (for LLCs), or buy-sell agreement or bylaws (for professional corporations or associations). These agreements effectively serve as a “pre-nup” for the new business partners. A wide variety of issues must be considered, but a few key issues are as follows:

i) Who will be on the primary governing board? Practices with multiple owners will typically have all owners on the governing board (such as an LLC board of managers). Larger entities may prefer to have senior owners on the governing board, with other owners limited to voting only on major issues.

ii) What votes will be needed to conduct actions and break deadlocks? Typically, each member of the governing entity (such as each manager of an LLC) will individually have the right to make routine decisions, such as purchasing supplies, whereas more significant decisions (such as hiring/firing employees, calling for additional capital contributions, signing leases and purchasing capital equipment) are made by a majority or supermajority vote. If not all owners are members of the governing body, their consent is typically required for major corporate actions such as mergers or other reorganizations. Unanimous consent may be required for some actions or for approvals given in writing as opposed to at a formal meeting. If unanimous consent is ever required, the parties should consider deadlock-breaking mechanisms or “unwind” provisions. For example, a neutral arbitrator may be appointed in the event parties cannot agree after all reasonable efforts.

iii) What will be appropriate transfer restrictions and buy-out values? This will be one of the more difficult areas to consider. Generally, a supermajority of the owners will want to consent to admission of new members, which dilutes everyone’s pro rata share of the practice. Voluntary and non-voluntary departures may require the owner interests to be re-purchased by the practice at an appraised fair market value or a fixed, agreed upon price (such as book value of assets or a multiple of average collections), with discounts if the departure was for cause. The governing documents may want to tie into termination provisions in any service or employee/contractor agreement.

Some practices actually implement a gradual process by which the younger dentists increasingly obtain a larger percentage of the practice, which eventually can leave the senior dentist with a minority interest. These processes may include reasonable measures to protect the senior dentist from losing complete control and the ability to transition into retirement (such as continuing management rights and/or an employment contract with a fixed term).

iv) What will be applicable non-competition and non-solicitation provisions? Proper and effective completion of these provisions requires legal counsel well-versed in drafting enforceable non-competition and non-solicitation provisions within the governing documents. The non-competition provisions may be included in the services or employee/contractor agreement. If duplicated, they must be consistent. Generally, the non-competition provision should be specific and reasonable, and should describe the scope of actions that are considered competitive, along with a specified radius that can be calculated accurately. A specified term of years must be present. Overly broad terms and an excessively long time period may cause resentment during negotiation and may not even be respected by the courts if litigated. The practice should consider protection of patient lists to avoid departed dentists from soliciting existing patients without the consent of the remaining dentists.

Given the investment in training for qualified hygienists and assistants, non-solicitation provisions are recommended to prevent solicitation or hiring of staff for a period of time after departure.

CONCLUSION

Bringing aboard an associate dentist, as this Article has shown, requires serious consideration of the consequences, and a significant investment of time and money in properly structuring the long-term relationship. The senior dentist must consider whether to initially hire an associate as an employee or independent contractor. The eventual status of the associate as an owner of the practice is especially involved, particularly if the senior dentist, as is typically the case, has practiced on his or her own for many years. By assembling a team of professionals, and with prior education and planning, the result will hopefully be a mutually beneficial and happy relationship for years to come.

REFERENCES

2) Today, nine dental specialties are recognized by the American Dental Association, most of which were adopted only in the last 15-20 years. American Dental Association, Definitions of Recognized Dental Specialties, available at http://www.ada.org/en/education-careers/careers-in-dentistry/dental-specialties/specialty-definition.
4) Some states allow dental, legal, and similar professional practices to be legally organized as “professional limited liability companies” or “PLLCs,” but Missouri does not recognize that designation; however, professionals may be organized as LLCs.